

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Houston Analyst: Gail Hall Bill Number: AB 906  
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 18, 2005  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Construction Or Rehabilitation Costs Of Qualified Development Credit

### SUMMARY

This bill would provide a credit to taxpayers for the rehabilitation of brownfield property.

### PURPOSE OF THE BILL

The author's staff has indicated that the purpose of this bill is to provide an incentive to redevelop property, create new jobs, and promote infill development in an effort to control urban sprawl yet increase the housing supply.

### EFFECTIVE/OPERATIVE DATE

As a tax levy this bill would be effective immediately and, by its terms, apply to taxable years beginning on or after January 1, 2005.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current federal law provides that a taxpayer may elect to treat qualified environmental remediation expenditures as an expense instead of an asset that is capitalized and depreciated over its useful life. California conforms to federal law for both individuals and corporations.

The California Health and Safety Code<sup>1</sup> refers to brownfields as sites located throughout the state that are abandoned, idle, or underutilized due to a combination of factors, including legal liability concerns, regulatory issues, and the costs of pollution cleanup.

<sup>1</sup> Section 44501(e)(1).

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A “brownfield site” is defined in the California Health and Safety Code<sup>2</sup> as a real estate parcel or improvements located on the parcel, which is abandoned, idled, or underused due to real or perceived environmental contamination. The environmental contamination includes, but is not limited to, soil or groundwater contamination, the presence of underground storage tanks, or the presence of asbestos or lead paint on the parcel or in the improvements located on the parcel. After assessment and planning, the parcel or improvements on the parcel must be determined to have a reasonable potential for economically beneficial reuse. This definition does not specifically provide that a brownfield site must be located in California.

“Mixed-use developments” are described in the California Government Code<sup>3</sup> as residential and nonresidential uses in which nonresidential uses are limited to neighborhood commercial uses, and to the first floor of buildings with two or more stories. “Neighborhood commercial” means small-scale general or specialty stores that furnish goods and services primarily to residents of the neighborhood.

### THIS BILL

This bill would allow a credit equal to 15% of costs paid or incurred for the construction and rehabilitation of a qualified development. The credit could be claimed by both a personal income taxpayer and a corporate taxpayer. A “qualified development” includes a development of property that is:

1. a brownfield site,
2. a mixed-use development, and
3. a development that combines high residential density with transit service accessibility.

The tax credit would reduce total tax, but not below zero or tentative minimum tax. Any unused tax credit would be carried forward for use in future years without limitation.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

1. The amount of credit is 15% of “costs” paid or incurred for the construction or rehabilitation of a qualified development. The term “costs” is not defined in this bill and may be broadly interpreted, i.e., tangible personal property, real property, labor costs, and indirect costs.
2. A definition for “high-density” is not provided in the bill. There is a definition of “high-density” in the Government Code<sup>4</sup> that may be used if appropriate.
3. On page 2, line 2, the term “includes” is used in the definition of a “qualified development.” If it is the intent of the author that the definition of “qualified development” is limited to property located on a brownfield, mixed-use development and a development that combines high residential density with transit service accessibility, the author may want to use the term “means” instead of “includes.”

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

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<sup>2</sup> Section 44504.1.

<sup>3</sup> Section 65589.5

<sup>4</sup> Section 65089.4

## LEGISLATIVE HISTORY

AB 2797 (Cardoza, Stats. 1998, Ch. 322) allowed a corporation and an individual to deduct, instead of capitalize, environmental remediation costs in conformity to federal law.

SB 203 (Romero, 2003/2004) would have allowed an income tax credit for the cost of cleaning up polluted brownfield property.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Generally, these states conform to federal law that allows a deduction for environmental remediation expenses. These states also provide a few brownfield credits relating to environmental clean up and redevelopment.

For tax years beginning on or after April 1, 2005, a Brownfield Redevelopment Credit is available against the *New York* corporate, utility, bank, and insurance franchise taxes, and against the personal income tax. The Brownfield Redevelopment Credit is equal to the sum of the site preparation, tangible property, and on-site groundwater credit components. The *New York* Commissioner of Environmental Conservation certifies each of these components. The costs that qualify for each component of the credit are defined in the statute. The credit ranges from 10% to 12%.

## FISCAL IMPACT

This bill would not significantly impact the department's costs because the changes necessary to implement this bill could be accomplished during the normal annual update.

## ECONOMIC IMPACT

### Revenue Estimate

Based on data and assumptions discussed below, the PIT and Corporation Tax revenue loss from this bill would be as follows:

| Estimated Revenue Impact of AB 906<br>Effective On Or After January 1, 2005<br>With Enactment Assumed After June 30, 2005<br>(\$ Millions) |         |         |
|--|---------|---------|
| 2005-06  | 2006-07 | 2007-08 |
| -\$5   | -\$10   | -\$15   |

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

The above estimate was based on the federal impact of expensing environmental remediation costs, and estimating that 12% of the remediation costs occurred in California. It is expected that the enactment of AB 389 (Montanez, Stats. 2004, Ch. 705) that allows innocent landowners to qualify for immunity from liability will be a positive incentive for the future use of the credits proposed by this bill.

It was assumed that there would be some lag time before the full impact of this bill is realized. On brownfield sites, there would be a certification process validating the safety of the site after clean up.

### ARGUMENTS/POLICY CONCERNS

The department has identified the following policy concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. This bill does not limit the number of years for the carryover period, which would require the department to retain the credit on the tax forms indefinitely. Recent credits have been enacted with no more than an eight-year carryover period since experience shows credits are typically used within that period of time.
2. Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense or is depreciable. This bill provides a credit for redevelopment costs that may also be deducted as environmental remediation expenditures. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.
3. The definition of a qualified development does not specifically provide that a qualified development must be located in California. If the credit would be applicable to qualified property regardless of where the property is located, this would defeat the targeted incentive purpose of this bill and could result in the credit claimed for brownfield redevelopments in other states. However, if the qualified development is required to be located in California, there is a potential constitutional issue. The U.S. Court of Appeals for the 6<sup>th</sup> Circuit ruled in *Cuno v. DamlerChrysler, Inc.* (2004) 386 F.3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

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